



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

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| Date Introduced: | 01/18/11 | Bill No: | Assembly Bill 153 |
| Tax Program: | Sales & Use Tax | Author: | Skinner |
| Sponsor: | Author | Code Sections: | RTC 6203 |
| Related Bills: | AB 155 (Calderon) SB 234 (Hancock) SB 655 (Steinberg) | Effective Date: | 01/01/12 |

BILL SUMMARY

This bill would specify that a “retailer engaged in business in this state” includes a retailer entering into an agreement with a California resident under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link or an Internet Web site or otherwise, to the retailer, under specified conditions.

ANALYSIS

CURRENT LAW

Under federal law, Article I, Section 8, Clause 3 of the United States Constitution, known as the Commerce Clause, states that Congress has the exclusive authority to manage trade activities between the states, with foreign nations, and Indian tribes. The "Dormant" Commerce Clause, also known as the "Negative" Commerce Clause, is a legal doctrine that courts in the United States have implied from the Commerce Clause. The idea behind the Dormant Commerce Clause is that this grant of power implies a negative converse — a restriction prohibiting a state from passing legislation that improperly burdens or discriminates against interstate commerce. The question of to what extent states can legally compel remote retailers to collect the tax, however, has been a subject of extensive disagreement.

Under existing state law, Chapter 3 (commencing with Section 6201) of Part 1 of Division 2 of the Revenue and Taxation Code, a use tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer. The use tax is imposed on the purchaser, and unless that purchaser pays the use tax to a retailer registered to collect the California use tax, the purchaser is liable for the tax, unless the use of that property is specifically exempted or excluded from tax. The use tax is the same rate as the sales tax and is required to be remitted to the BOE on or before the last day of the month following the quarterly period in which the purchase was made or a purchaser may report the tax on the purchaser's state income tax return (if that purchaser is not registered with the BOE).

Section 6203 of the Sales and Use Tax Law describes various activities which constitute “engaging in business in this state” for purposes of determining whether an out-of-state retailer has sufficient business presence (also known as “nexus”) in California such that the state will impose a use tax collection responsibility on sales made to California consumers. If a retailer has sufficient business presence within the terms of Section

6203, that retailer is required to register with the BOE pursuant to Section 6226 and collect the applicable use tax on all sales to California consumers.

Under Section 6203, the following retailers are considered “engaged in business in this state” and are required to collect the California use tax on sales made to California consumers:

- (1) Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business.
- (2) Any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property.
- (3) Any retailer deriving rentals from a lease of tangible personal property situated in this state.

The BOE’s Regulation 1684, *Collection of Use Tax by Retailers*, clarifies Section 6203 and specifies that the use of a computer server on the Internet to create or maintain a web page or site by an out-of-state retailer is not considered a factor in determining whether the retailer has a substantial nexus with California. The regulation further clarifies that an Internet service provider or other Internet access service provider, or World Wide Web hosting services shall not be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.

PROPOSED LAW

This bill would amend Revenue and Taxation Code Section 6203 of the Sales and Use Tax Law to specify that a “retailer engaged in business in this state” includes any retailer entering into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers of tangible personal property, whether by a link or an Internet Web site or otherwise, to the retailer, if the cumulative gross receipts or sales price from sales by the retailer to customers in this state who are referred pursuant to these agreements is in excess \$10,000 during the preceding four calendar quarterly periods.

The bill clarifies, however, that these provisions shall not apply if the retailer can demonstrate that the resident with whom the retailer has an agreement did not engage in referrals in the state on behalf of the retailer that would satisfy the requirements of the commerce clause of the United States Constitution during the four quarterly periods in question.

The provisions of the bill would become operative January 1, 2012.

BACKGROUND

One of the greatest controversies in the field of state taxation today concerns the constitutional authority of the states to impose a use tax collection responsibility on goods purchased from out-of-state retailers – either through mail order or over the Internet.

Under constitutional law, states lack jurisdiction to require out-of-state retailers to collect a sales or use tax when the retailer has no "physical presence" in the taxing state. In 1992 the Supreme Court issued a ruling in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298 and held that satisfying due process concerns does not require a physical presence, but rather requires only minimum contacts with the taxing state. Thus, when a mail-order business purposefully directs its activities at residents of the taxing state, the Due Process Clause does not prohibit the state's requiring the retailer to collect the state's use tax. However, the Court further held that physical presence in the state was required for a business to have a "substantial nexus" with the taxing state for purposes of the Commerce Clause. The Court therefore affirmed that in order to survive a Commerce Clause challenge, a retailer must have substantial nexus in the taxing state before that state can require the retailer to collect its use tax.

For example, when a California resident purchases a coat from L.L. Bean, Inc. through its web site, the purchaser's use of that coat in California is subject to California's use tax. The most practical means for the state to enforce the tax is to have L.L. Bean, Inc. collect the tax at the time of sale. However, because L.L. Bean, Inc. does not have substantial nexus in California (e.g., it neither owns nor rents property in the state, hires no employees or independent contractors here, and delivers all of its merchandise into the state through common carriers), California is constitutionally prohibited from requiring L.L. Bean, Inc. to collect the tax. If the purchaser fails to remit the tax to California, and escapes sales or use taxation, a tax gap is created.

It is estimated that this gap in California's sales and use tax system costs the state over \$1.145 billion in state and local tax revenues (\$795 million in uncollected use tax from California consumers; \$350 million from businesses).

New York, Amazon, and Overstock.com. The state of New York, as part of its budget, enacted legislation in 2008 entitled "the Commission-Agreement Provision" that presumes a retailer "solicits" business in the state if an in-state entity is compensated for directly or indirectly referring customers to the retailer – language that is substantially similar to this measure, and now commonly referred to as "click through nexus." In April 2008, Amazon sued New York's taxation department. Then, in May 2008, Overstock suspended its relationships with any affiliates that had a New York address. And in June 2008, the company joined Amazon in its suit, challenging the constitutionality of the tax law.

Both Amazon and Overstock contended that the law violates the Commerce Clause of the U.S. Constitution and the Due Process Clause of the Fourteenth Amendment to the Constitution and sought a permanent injunction prohibiting New York from enforcing the law.

Seattle-based Amazon argued that it did not have a sufficient nexus (physical presence) in the state to be compelled to collect use tax and basically contended that the new law intentionally targets Amazon. Additionally, Amazon said the law is vague and overly broad because Amazon has no way of knowing whether its affiliates, who provide addresses in other states, are legal residents of New York.

The New York Supreme Court dismissed both the Amazon and Overstock suits, ruling that New York's Commission-Agreement Provision does not broadly tax any and all Internet sales to New York consumers in that it requires a substantial nexus between an out-of-state seller and New York through a contract to pay commissions for referrals

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with a New York resident along with realization of more than \$10,000 of revenue from New York sales earned through the arrangement. Further, the Court stated that the neutral statute simply obligates out-of-state sellers to shoulder their fair share of the tax collection burden when using New Yorkers to earn profit from other New Yorkers.

In May 2009, Amazon and Overstock directly appealed to the New York Court of Appeals. The Court of Appeals transferred the appeals to the Appellate Division of the New York Supreme Court. On appeal, Amazon did not pursue its facial challenge based upon the Commerce Clause, but argued that, (1) as applied to it, the statute is unconstitutional because Amazon lacks a "substantial nexus" within the State; (2) the statute violates the Due Process Clause because, facially and as applied, it enacts an irrational and irrebuttable presumption, and also is vague; and (3) the statute violates the Equal Protection Clause because it targets Amazon in bad faith.

In its decision rendered in November 2010, the appellate court modified the trial court judgment by declaring that the statute is constitutional on its face, and does not violate the Equal Protection Clause either on its face or as applied. Then, the matter was remanded for further proceedings with respect to the as-applied challenges under the Due Process and Commerce Clauses (in other words, the court could not make a determination on whether Amazon could meet the burden on these issues based on the record, so a remand was issued to the trial court to take further evidence). The remainder of the trial court judgment was affirmed.

Because this is a constitutional issue, the matter ultimately could be pursued to the U.S. Supreme Court.

Past legislative efforts focused on imposing a use tax collection obligation on out-of-state retailers. The rapid development and growth of the Internet in the 1990's resulted in fundamental changes in the manner in which transactions occurred between and among businesses and individuals. As a result, various legislative proposals have been introduced over the past decade to broaden California's ability to impose a use tax collection requirement on out-of-state retailers. For example, in 1999, California brick-and-mortar book retailers began seeking assistance from the Legislature to level the playing field for those Internet book retailers who claim to be out-of-state remote sellers but who are, in reality, California brick-and-mortar businesses.

Specifically, at that time, local booksellers believed the Borders online and Barnes and Noble online stores should be required to collect the California use tax on their sales to California consumers just as their California "bricks-and-mortar" stores collect sales tax reimbursement. These out-of-state retailers had formed separate legal entities from their corporate affiliates to sell similar goods as in the "bricks-and-mortar" stores throughout the country, including California, and believed they were not required to collect the California use tax. In response AB 2412 (Migden and Aroner) was introduced in 2000 to clarify that a retailer is presumed to have an agent within the state if the retailer is related, as specified, to a retailer maintaining sales locations in this state, provided the retailer sells similar products under a similar name as the California retailer, or facilities or employees of the related California retailer are used to advertise or promote sales by the retailer to California.

The Legislature passed the bill; however, Governor Davis vetoed it, stating:

“This bill would impose sales tax collection obligations on retailers who process orders electronically, by fax, telephone, the Internet, or other electronic ordering process, if the retailer is engaged in business in this state.

“In order for the Internet to reach its full potential as a marketing medium and job creator it must be given time to mature. At present, it is less than 10 years old. Imposing sales taxes on Internet transactions at this point in its young life would send the wrong signal about California’s international role as the incubator of the dot-com community.

“Moreover, the Internet must be subject to a stable and non-discriminatory legal environment, particularly in the area of taxation. Unfortunately, AB 2412 does not provide such a stable environment: it singles out companies that are conducting transactions electronically and attempts to impose tax collection obligations on them to which, according to California courts, they are not subject. Furthermore, AB 2412 re-enacts provisions that the Legislature has recently repealed due to court decisions.

“In the next 3 to 5 years, however, I believe we should review this matter. Therefore I am signing SB 1933, which creates the California Commission on Tax Policy in the New Economy. The Commission will examine sales tax issues in relation to technology and consumer behavior and make recommendations.”

(Throughout this same period, the BOE considered appeals from these online retailers that had been assessed use tax on their sales to California consumers. The BOE prevailed in Borders Online, LLC v. State Board of Equalization (2005) 129 Cal.App.4th 1179, and reached a settlement agreement with Barnes and Noble.com. Subsequently, both online retailers began collecting California use tax.)

Then, early in 2001, the authors introduced AB 81 (Migden and Aroner) which was substantially identical to AB 2412. Later in the session, the provisions in AB 81 related to the Sales and Use Tax Law were gutted, and replaced by unrelated property tax provisions.

During the 2003-04 Session, SB 103 (Alpert) was introduced to include provisions similar to AB 81 and AB 2412, but it also included a provision that specified that a retailer engaged in business in this state includes any retailer having, among others, any representative or independent contractor operating in this state under that retailer’s authority for the purpose of servicing or repairing tangible personal property. That measure was subsequently gutted and amended on the Assembly Floor with unrelated provisions.

During the 2007-08 Session, Assembly Member Calderon introduced two other measures that would have imposed a use tax collection duty on out-of-state retailers to the extent allowable under the law. Both AB 1840 and ABx3 2 would have provided that a “retailer engaged in business in this state” means any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty. AB 1840 failed passage on the Assembly floor and ABx3 2 was never heard in committee.

During the 2009-10 Legislative Session and various extraordinary sessions during that period, seven more bills containing “click through nexus” provisions (similar to this bill) were introduced. Only one passed the Legislature – SBx3 17 (Ducheny). However,

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SBx3 17 also contained several other provisions related to tax enforcement and tax administration, and was vetoed by Governor Schwarzenegger. His veto message related to the bill as a whole, and not specifically to this particular provision.

Recent legislative efforts focused on use tax collections from California purchasers. In an effort to increase the public's awareness of the use tax and to encourage voluntary compliance in reporting the use tax, legislation enacted in 2003 (SB 1009, Ch. 718) required the Franchise Tax Board to revise the personal income tax and corporation tax returns to add a separate line for use tax reporting and accompanying instructions in the booklet. This legislation allowed consumers and businesses that are not required to be registered with the BOE to report use tax on their state income tax returns for purchases made on or after January 1, 2003, and through December 31, 2009, as an alternative to reporting the tax to the BOE (businesses and certain consumers already registered with the BOE, however, may not use this alternative). SB 858 (Ch. 721, 2010) eliminated the sunset date.

However, in 2007, 2008 and 2009, the BOE has sponsored legislation to not only eliminate the sunset date of these provisions, but to also *require* businesses and consumers who have failed to report use tax to the BOE on their taxable purchases for the preceding year to report the use tax on the income tax returns for the taxable year in which the liability for the qualified use tax was incurred. However, none of these attempts was successful. The first and third attempts (AB 969, 2007, Eng and AB 469, 2009, Eng) were vetoed by the Governor, and the second attempt (AB 1957, 2008, Eng) failed passage in the Senate Revenue and Taxation Committee.

During 2009's Fourth Extraordinary Session, ABx4 18 (Ch. 16) was enacted to impose a use tax registration and reporting obligation on larger businesses. Under this bill, businesses (except for those already registered to report sales or use tax) that have annual gross receipts from business operations of at least \$100,000 annually, are required to register with the BOE and file an annual use tax return and report their purchases subject to use tax. Since its enactment, this bill has resulted in additional collections of \$32 million in use tax, interest and penalties.

COMMENTS

- 1. Sponsor and Purpose.** This bill is sponsored by the author to provide "e-fairness" by ensuring that out-of-state online retailers that do business in California remit to the state sales tax in the same way California businesses must. According to the author, "this legislation will close the current loophole in California tax law which has allowed out-of-state companies to avoid collecting California sales and use tax. Out-of-state online retailers designed their business model to avoid collecting sales tax. This puts our Main Street businesses, who play by the rules, at a competitive disadvantage. It's not fair to hurt California businesses who are struggling to keep their doors open."
- 2. Is this form of affiliate nexus constitutional?** Nineteen years have passed since the court rendered its decision in Quill. However, the manner in which business is done now has changed dramatically compared with the commercial landscape at the time that case was decided. The New York Appellate court has determined that these provisions are not unconstitutional on their face. However, there is still some question with respect to New York's provisions (after which this bill is modeled) whether they are constitutional as they are applied. Until the court ultimately

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decides that the *physical* presence requirement affirmed in Quill is outdated, and renders a new decision to reflect today's marketplace, there is at least some question whether this form of affiliate nexus will be ultimately found to be in conformance with the dormant commerce clause.

3. **In addition to firms like Amazon, provisions could impact many other out-of-state retailers who sell tangible items on eBay or other similar online marketplaces domiciled in California.** As currently worded, the provisions would apply to those out-of-state retailers that are not otherwise engaged in business in California but that sell goods to California consumers through online sites maintained by California residents when all of the conditions in the bill are met. An out-of-state retailer's sales through eBay, for example, where eBay refers potential purchasers for a commission or other consideration to the retailer by a link or otherwise, could fit within the provisions of this bill (eBay is a California "resident"). If those sales exceeded \$10,000 within the previous 12 months, that out-of-state retailer would be considered "engaged in business" in this state under this bill. As a retailer engaged in business in California, the retailer would be required to register with the BOE and would have the duty to collect the use tax on all of his or her sales to California consumers – whether through eBay or otherwise.
4. **Affiliates' concerns.** According to information obtained from Performance Marketing Association, California has about 25,000 affiliates who derive income from agreements with out-of-state retailers that potentially could be negatively impacted by this bill. Their concern relates to the fact that many out-of-state retailers with affiliate programs will terminate their agreements with them should California enact this provision. Overstock.com did, in fact, terminate its affiliate program in New York – the first state that enacted this "click through nexus" provision, and Amazon terminated its affiliate programs in Rhode Island and North Carolina when those states enacted provisions similar to this bill. Amazon even terminated their relationship with Colorado's affiliates when the Colorado Legislature enacted provisions to impose an information reporting requirement on remote retailers that do not have nexus in Colorado. And, a "click through nexus" bill is currently awaiting the Governor's signature in Illinois, and Amazon has informed its affiliates there that Amazon's affiliate program with them will terminate should the bill become law. And, more importantly, we have also obtained written confirmation directly from Amazon that confirms that it will terminate its relationship with its 10,000 California affiliates should California enact this provision.
5. **What are other states doing?** In addition to pending legislation in Illinois on this "click through nexus" provision, several other states are considering adding a similar provision: Arizona, Hawaii, Minnesota, Mississippi, New Mexico, Connecticut, Texas and Vermont. Also, a bill to repeal its "click through nexus" provision has been introduced in Rhode Island.
6. **Related legislation.** Three other bills have been introduced that would expand the provisions in California law that impose a use tax collection obligation on out-of-state retailers. AB 155 (Calderon), SB 234 (Hancock), and SB 655 (Steinberg) would specify that any out-of-state retailer that has substantial nexus with this state for purposes of the Commerce Clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty is a "retailer engaged in business in this state." In addition, AB 155 would:

- Specify that a retailer that is a member of a commonly-controlled group and a member of a combined control group that includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer performs services in this state in connection with tangible personal property to be sold by the retailer, as specified, is a "retailer engaged in business in this state."
- Delete other provisions that exclude specified activities from the term, "engaged in business in this state."
- Require retailers that are not engaged in business in this state that sell tangible personal property to California consumers to provide information about use tax on its Internet site and any retail catalog, and provide specified information to the BOE and customers.
- Impose a penalty on those retailers for failing to comply.

COST ESTIMATE

The BOE would incur costs to administer this bill. These costs would be attributable to notifying affected out-of-state retailers and ensuring compliance, potential litigation costs, and costs related to revising the BOE's Regulation 1684 and related publications, and answering inquiries. An estimate of these costs is pending.

REVENUE ESTIMATE

The revenue impact from this proposed change to the definition of a "retailer engaged in business in this state" is subject to considerable uncertainty. And, there could be an unknown delay of any revenues due to potential litigation arising from enactment of this provision. In a purely static world (no behavioral changes resulting from the change in tax policy) with full compliance, we estimate that the proposed change would lead to a state and local revenue increase of \$152 million in 2011-12 (a half-year effect) and \$317 million in 2011-12. These estimates are based on the combination of (1) the amount of revenues currently being collected in New York, adjusted for California's larger economy, and (2) increased revenues associated with out-of-state retailers that sell to California consumers on eBay that would have a use tax collection obligation under the provisions of this bill (see Comment 3).

However, the State's likelihood of actually realizing these revenues depends entirely on (1) Internet retailers' (such as Amazon and Overstock) willingness to continue their affiliate programs, and (2) other retailers' willingness to continue to sell on eBay and to fully comply with the added use tax collection obligations imposed by this bill. We have received direct confirmation from Amazon that it will terminate its relationship with its 10,000 California affiliates should this measure become enacted. We estimate that Amazon currently comprises roughly 50 percent of the Internet sales of large firms who currently do not have nexus in California. Consequently, the static revenue estimates cited above, adjusted for Amazon's response, would drop to \$114 million in 2011-12 and \$234 million in 2012-13. If other firms were also to terminate their affiliate programs in response to the enactment of this bill, the potential revenue gain would be further diminished. Similarly, while we lack the data to determine to what extent out-of-state retailers would discontinue their use of eBay to sell to California consumers, any drop in such eBay usage would even further lower the revenue gain.

Additionally, the termination of affiliate programs would have an adverse impact on state employment, which in turn would lead to lower revenues from sources such as the personal income tax and the corporation tax. The amount of these potential reductions is unknown.

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